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FAILED THRIFTS: GAO's Analysis of Bank Board 1988 Deals

Statement of
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Before the
Committee on Banking, Housing
and Urban Affairs
United States Senate

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SUMMARY OF STATEMENT BY
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GAO's analysis of Federal Home Loan Bank Board 1988 deals to resolve failed thrifts has intensified GAO's earlier reservations about the appropriateness of the deals.

-- The way purchasers for the Texas thrifts were solicited and selected may not have enabled FSLIC to attract the largest pool of qualified prospective acquirers and may not have resulted in the best terms possible.

-- The costs to FSLIC will be higher than estimated if the guaranteed assets do not have the projected values or if interest rates increase. Also, the new thrifts lack incentives to most effectively manage and liquidate the guaranteed assets.

-- GAO's estimate of the potential tax benefits to the acquirers for the 1988 transactions is between $7 billion and $8 billion on a present value basis. This is between about 20 and 40 percent higher than what FSLIC estimated. Moreover, FSLIC did not adequately take these benefits into account when negotiating the agreements. In deciding whether merger or liquidation was least costly, FSLIC was not legally required to consider the cost of the tax benefits. But GAO's analysis suggests that, if the full cost of the deals to the Government is considered, liquidation would have been cheaper in as many as a third of the 12 transactions GAO reviewed.

-- Some purchasers will recover their capital investments very quickly because of the tax benefits--in an average of 3 years in 9 of the transactions. The range is from 1 to 5 years. The new thrifts are also thinly capitalized, a situation which has historically provided incentives to take risks.

-- GAO questions whether FSLIC presently has the resources for the extensive monitoring these complex deals require.

GAO believes the Government should review the deals to take advantage of provisions to reduce its cost. But this action, which includes buying notes and assets, is dependent on the Government having sufficient funds.

Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss the Federal Savings and Loan Insurance Corporation (FSLIC)-assisted sales of failed thrifts approved by the Federal Home Loan Bank Board in 1988. This work was done in response to the October 20, 1988, request from you and five other Senators to select and assess five transactions and your December 30, 1988, request concerning the December 1988 transactions.

During 1988, the Bank Board acted on some 220 thrifts at an estimated present value cost to FSLIC of about $37 billion. Of this total, 179 thrifts were sold to acquirers in 86 transactions at a present value cost of $28.4 billion. Seventy-five of the 179 thrifts were sold in 34 transactions in December. We reviewed 12 transactions--5 that occurred before December, the 5 Southwest Plan December transactions, and the 2 largest non-Southwest Plan transactions. Of the 12, 8 were Southwest Plan transactions. (Table 1.)

Our analysis of these transactions has reinforced the views we have expressed previously to your Committee and increased our concerns about the appropriateness of the deals.

-- The costs to FSLIC will be higher than estimated if the guaranteed assets do not have the projected values or if interest rates increase.

-- Our estimate of the tax benefits for the 1988 transactions is between $7 billion and $8 billion in present value terms--about 20 to 40 percent higher than FSLIC estimated. FSLIC did not explicitly take these benefits into account, nor were they legally required to, when they chose to merge institutions rather than liquidate them.

-- If the full cost of the deals to the federal government is considered, our analysis suggests that liquidation could have been cheaper in as many as a third of the transactions we reviewed.

-- It appears that tax benefits will enable some purchasers to recover their capital investments very quickly. For the 12 transactions examined, we estimate the investment in as many as three-fourths can be recaptured in an average of 3 years, ranging between 1 and 5 years.

-- The new thrifts are thinly capitalized, a situation which historically provides incentives to take risks.

-- There is a lack of sufficient incentives for the new thrifts to effectively manage and liquidate the guaranteed assets to minimize FSLIC assistance costs.

-- The selection process was loosely structured and administered inconsistently. The process may have decreased the pool of prospective bidders, inhibited FSLIC's ability to evaluate the acceptability of proposals, and resulted in a less efficient use of FSLIC resources.

-- The new thrifts have competitive advantages over unassisted thrifts.

-- FSLIC and the Bank Board have included complex control features in the agreements. But we question whether FSLIC can administer these extensive monitoring provisions with present resources.

Based on these points, we believe the deals should be carefully reexamined. The administration's bill authorizes the Resolution Trust Corporation to make such a review. Options that would be used to reduce the government's costs include prepayment of negative net worth notes and purchase of guaranteed assets. Of course, the government's ability to exercise such options depends on the availability of adequate funding.

TRANSACTION COSTS

We are concerned that the costs of the 1988 transactions may exceed the FSLIC estimates--about $37 billion in present value

terms or about $62 billion on a cash basis.

-- The financial condition of the failed thrifts is not known. Initial audits are to be conducted, for example, at the new thrifts in Texas to determine, among other things, the amount of the negative net worth note. While no such audit has yet been approved, we understand that for one thrift the note may be increased by about two-thirds.

-- FSLIC assumed, in making cost estimates for the Texas transactions we examined, that interest rates would only rise 1 to 1 1/2 percent over the 10 year period of the Southwest Plan assistance agreements. If interest rates increase more, the costs to FSLIC will rise.

TAX BENEFITS

The total cost to the government will probably be higher than FSLIC has estimated because of the tax benefits to the acquirers.

Special provisions in the Internal Revenue Code grant substantial tax benefits to acquirers of insolvent thrifts. FSLIC often shares in these benefits. One provision makes the sale of insolvent thrifts eligible for tax-free treatment as a reorganization without meeting all the usual requirements. Qualification as a tax-free reorganization and other special

provisions allow the acquired thrift's preagreement net operating losses (NOLs) to be deducted against the future income of the new thrift.

The rules also enable the new thrift to carry over the full value of assets from the acquired thrift. Because this value is generally higher than the fair market value, there is a loss when the assets are sold. This "built-in" loss is deductible against the new thrift's income and may also be used to offset income of a holding company which owns the thrift.

Other special provisions provide that FSLIC assistance is excluded from taxable income and is not reflected in the tax basis of the new thrift's assets. The principal types of FSLIC assistance payments are: guaranteed returns on assets; interest on FSLIC notes; negative net worth notes; and reimbursements for expenses and built-in losses. The use of these benefits was extended for transactions entered into in calendar year 1989, but reduced by 50 percent.

FSLIC provided us with projections of the tax consequences of the 1988 transactions and the basis on which they made these calculations on February 9, 1989. They showed total tax benefits of $5.7 billion when calculated in present value terms.

For the 86 transactions resolved in 1988, we estimate the tax

benefits, on a present value basis, to be between $7 billion and $8 billion. This is consistent with both Treasury and the Joint Committee on Taxation estimates and is about 20 to 40 percent more than FSLIC estimated.

We estimated that the tax benefits for the 12 transactions on which we focused are over $5 billion on a present value basis--about 20 percent higher than the $4 billion plus FSLIC estimated.

Our estimate is different from FSLIC's because we used different assumptions. After discussions with tax experts from Treasury and the Joint Committee on Taxation, we decided to use a different weighted tax rate to reflect our assumption that the tax benefits would offset more income at the normal 34 percent corporate rate rather than at the 20 percent alternative minimum tax rate. We reduced the combined benefits of built-in-losses and income maintenance payments by assigning a tax basis to them as indicated by current IRS administrative practice. Because of tax planning opportunities that are available, we assumed more NOLs will be used.

This is the major reason our estimate is higher than FSLIC's. FSLIC did not consider tax planning but rather relied on their income projections for the new thrifts. We also used a 10-year Treasury rate in calculating the present value of the benefits.

Using these different assumptions for each of the 12 transactions reviewed, we compared the full government cost of the assisted transactions to the FSLIC cost of liquidating the failed thrifts. Our analysis suggests that liquidation could have been less costly for as many as a third of the transactions. FSLIC, however, was not statutorily required to consider tax benefits in deciding whether merger was less expensive than liquidation.

We also estimated the timeframes in which the acquirers' capital[1] could be recovered through tax benefits. In 9 of the 12 transactions, we estimate that the acquirers' tax benefits would equal the capital within an average of 3 years. The range was from 1 to 5 years. Two of the remaining transactions gave all the tax benefits to FSLIC. The other remaining one will not recover the capital through tax benefits during the period studied.

I want to emphasize that determining accurately the tax consequences of these transactions is very difficult. The true market value of failed thrifts' assets, which affects the tax, is not known, nor is the timing of asset sales. The future profitability of the new thrift and any holding company is difficult to estimate. And, it is difficult to anticipate the future business decisions of the new owners in light of the tax

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[1]Capital, for the purpose of this analysis, does not include subordinated debt.

benefits available.

FHLBB officials have said that the tax benefits of the transactions were treated like any other asset and included in the negotiations. FSLIC did not have sufficient information to undertake an evaluation of tax benefits at the time the transactions were approved. FSLIC did not estimate the tax benefits of its 1988 transactions until January 1989. It seems highly unlikely that FSLIC got full value for these benefits in all the transactions.

The special tax benefits, which now apply to banks as well as thrifts, are used in the resolution of insolvent institutions. The need for the continuation of the special tax provisions depends on the extent to which FSLIC and FDIC are able to resolve failed institutions using insurance funds alone. In this regard, we believe it would be far preferable to take the actions we have recommended[2] to ensure the financial soundness of the insurance funds so that the insurers have the means to pay for, and thus fully recognize, resolution costs, rather than resorting to using special tax benefits.

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[2]Troubled Financial Institutions: Solutions to the Thrift Industry Problem (GGD-89-47, Feb. 1989).

LACK OF INCENTIVES TO MANAGE ASSETS

The provisions of the agreements may not provide sufficient incentives for acquirers to actively manage and liquidate assets in the least costly manner to FSLIC and the federal government. Certain provisions shield the acquirers from loss on asset sales below book value and provide FSLIC with most of any gain above book value. Other provisions reduce the guaranteed return rate on covered assets over the term of the agreement but also guarantee a cash inflow for specified periods.

While FSLIC usually reimburses the new thrift for any difference between book value and recovery, the thrift can use the amount of the difference as a tax deduction. It is thus to the acquirer's benefit--from a tax perspective--to sell assets at the lowest percentage of book value, thus generating the largest loss. Also, if the acquirer increases the return on a covered asset, the FSLIC tax-free payment is reduced. Any return the asset actually generates is taxable.

Selling assets also reduces the covered asset pool and thus the amount of assets for which yield maintenance is provided. FSLIC attempted to provide incentives for acquirers to manage and dispose of assets most effectively by including gain and loss sharing agreements. All 12 transactions we reviewed included a gain sharing agreement; the provisions varied considerably. Five

transactions included loss sharing agreements.

The yield maintenance guarantees, 10 years for Southwest Plan transactions and one other and 5 years in another one, decline over the period as an incentive to dispose of assets. Two transactions did not include a yield guarantee. Rates for the 8 Southwest Plan transactions ranged from 220 to 275 basis points over the average Texas cost of funds in year 1 to 90 to 200 points in year 10. These rates are meant to provide for operating expenses associated with the assets and profit. FSLIC was unable to estimate how much of the premium would be profit after operating expenses.

There is no certainty that the reductions in guaranteed yield agreements provide enough incentive for acquirers to properly manage and dispose of property. The acquirers' plans to sell an asset could be influenced by several factors, one would be any gain or loss sharing agreement with FSLIC. Another is the amount of profit included in the yield guarantee compared to the expected net profit after tax from reinvesting the proceeds from the sale. A final consideration would be the best timing for the use of tax benefits from the capital loss deductions.

Provisions in the transactions give FSLIC some control over the acquirers' management and disposition of assets. A typical provision obligates the acquirer to use its best efforts to

manage and liquidate assets in a manner that will minimize losses. Also FSLIC may, for example, require an acquirer to sell a covered asset. We have concerns, however, about the enormous monitoring job facing FSLIC and how realistic it is to expect FSLIC to effectively utilize these controls.

SOLICITATION AND SELECTION

The Bank Board and FSLIC operate under very broad statutory guidelines with respect to soliciting and selecting acquirers for insolvent thrifts. The Bank Board's general procedures for marketing insolvent thrifts under its Southwest Plan, implemented in the Federal Home Loan Bank System's Ninth District, differed from procedures used elsewhere.

For example, most investors were asked to submit initial proposals without knowing which thrifts were being marketed, how FSLIC planned to combine them in groups, or the thrifts' current financial condition. This "blind" process, along with FSLIC's practice of combining less desirable insolvent thrifts in packages with those for which there was more interest, may have (1) decreased the likelihood of attracting the largest pool of qualified prospective bidders, (2) inhibited FSLIC's ability to evaluate the acceptability of proposals it did receive, and (3) resulted in a less efficient use of FSLIC's limited resources.

To enhance the probability of success, the plan targeted potential acquirers before the bidding process formally began. Then, FSLIC solicited proposals from interested thrift and nonthrift investors, including the targeted acquirers already identified and investors who had submitted proposals for, or expressed interest in purchasing Texas thrifts.

A few FSLIC officials, assisted by district bank staff and under the Bank Board's guidance, evaluated the proposals that were received on the basis of how well they met the Plan's objectives and decided whether each was acceptable under the Plan. These officials also decided which package of thrifts was best suited for each acceptable investor. The investors considered acceptable for a specific package were then told the identities of the thrifts in that package and requested to submit a detailed proposal. The bidders were not allowed to visit the subject thrifts or review their accounts. After detailed proposals were received, FHLBB staff and private contractors representing FSLIC negotiated the final terms of the transactions.

One of the primary problems with the Southwest plan process was the lack of knowledge about the condition of the thrifts and the continuing efforts of FSLIC officials putting together the deals to "mix and match" insolvent thrifts to match the apparent capacity of acquirers to put up capital and manage thrifts. The process was very fluid. And in several cases bidders became

insolvent and became part of the packages.

There was no typical transaction. In one Southwest Plan transaction, the Plan had identified a particular thrift as a targeted acquirer for one of the packages of thrifts. The FSLIC official who led the early negotiations said that thrift was told the identity of the thrifts in the package as part of the process of identifying targeted acquirers. Subsequently that thrift and 14 other bidders expressed interest in one or more of the insolvent thrifts in the package in response to FSLIC's request for proposals. The targeted thrift contacted by FSLIC was the only one which bid on all thrifts in the package. After reviewing the 15 bids, FSLIC and district bank staff selected that thrift as the one with which to begin negotiations.

Negotiations began in May 1988. The acquiring thrift's proposal would have left the new thrift with RAP capital of 1.5 percent. By July, FSLIC discovered the acquiring thrift was having trouble with its own solvency, and required it to raise additional capital to complete the transaction.

The thrift contacted a private investor which agreed to provide the needed capital. However, before completing the transaction, the investor hired an audit firm to evaluate the acquiring thrift's accounts. The audit and a district bank examination revealed the acquiring thrift's assets had been substantially

overvalued and, in fact, the thrift was later found to be insolvent.

FSLIC ended negotiations with that thrift and placed it in the package of thrifts to be merged. FSLIC then added additional thrifts from another package to this package and started negotiating with the investor for the whole package of thrifts. The new package was not rebid to anyone else. The deal was then completed.

In contrast, a different process was used in one deal we reviewed that was not a part of the Southwest Plan. In this transaction, FSLIC asked 239 potential investors from its National Marketing List to attend a marketing conference if they were interested in bidding on certain insolvent thrifts with a certain asset size. The 25 investors who attended the conference were provided specific financial and other data on the thrifts. The bidders were allowed to review the accounts of the insolvent thrifts, a process called due diligence. Three proposals were received and cost estimates were made for each one. One was rejected because it exceeded the cost of liquidation. Negotiations started with the low cost bidder but broke down when that bidder could not obtain the financing needed for its proposal. Negotiations then started with the other bidder and finalized the deal.

COMPETITIVE ADVANTAGE

The assisted thrifts have certain financial advantages and protections that unassisted depository institutions do not. The advantages stem from the relatively low level of acquirer capital, the FSLIC assistance and guarantees, forbearances, and the tax savings.

As we have stated previously, the capital provided by acquirers is low in relation to the size of the thrift and this has historically created incentives to take risks.[3]

Having FSLIC assistance means the acquirer can count on some income for up to 10 years, regardless of what happens in the economy or thrift industry. For the 8 Southwest Plan transactions we reviewed, FSLIC estimates show its assistance makes up from about 50 to over 80 percent of projected gross income within the first five years.

Thrifts are now required to have a regulatory capital/liability ratio of 3 percent, rising to 6 percent at a rate tied to profitability in the industry. The 12 transactions resulted in 15 new thrifts. Financial information as of December 31, 1988, was available for 14. Capital to total liabilities ratios in 7

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[3]Failed Thrifts: Bank Board's 1988 Texas Resolution (GGD-89-59, Mar. 1989).

of the 14 was below 3 percent.

FSLIC also provides forbearances from other requirements, such as transactions with affiliates in the holding company. Forbearances shield the thrift from supervisory actions, and also let them undertake activities normally allowed for fully capitalized thrifts only. The FHLBB states that thrift supervisors have various controls over these forbearances.

Another advantage is that the new thrifts in Texas can use not only the FSLIC note to collateralize advances from the Federal Home Loan District Bank but also estimated future payments from FSLIC as collateral.

MONITORING MECHANISMS

Because of the complex nature of the transactions, FSLIC will have to monitor the assisted thrifts for lengthy periods of time. We question whether FSLIC has the resources to do this well.

One safeguard in most transactions is the provision in an agreement that FSLIC may take control of the new thrift if its regulatory capital drops to a certain level--often between 1 and 2 percent. Also, FSLIC may limit the payment of dividend under certain circumstances.

The complex agreements present a huge monitoring job for both FSLIC and Bank Board examiners and supervisors. The assistance agreements include a large number of controls. For example, FSLIC must approve: asset schedules, asset summaries; asset plans for large assets; asset budget summaries; asset sales requests; and asset term sheets if the thrift is providing the financing. For the 5 pre-December transactions we reviewed, there are over 87,000 covered assets with a book value of $7.1 billion. The 3 pre-December 1988 Southwest Plan thrifts had 552 large (over $5 million or $6 million) assets, each requiring a detailed asset plan.

Thrifts are also required to submit litigation schedules and reports; FSLIC must approve plans and budgets for significant litigation. (FSLIC reimburses the thrift for these expenses). FSLIC must also review reports showing the tax benefits of the transaction in the prior year; FSLIC can assess if it is receiving the percentage of the benefit agreed upon. FSLIC also reviews itemized charges for yield maintenance and capital loss payments submitted quarterly for payment. For Southwest Plan transactions, the new thrifts are required to submit three different consolidation plans for approval.

We have asked FSLIC for information on the pre-December transactions concerning the number of plans or reports submitted by thrifts, whether they were submitted on schedule, and how many

FSLIC has approved or denied. We also have asked for summary information on the monitoring requirements for the December transactions. FSLIC does not maintain such information centrally and was still in the process of obtaining it from the assisted thrifts for us as we were preparing this testimony.

VIABILITY OF NEW THRIFTS WAS CONSIDERED

The viability of the new thrifts is important to FSLIC because it insures the deposits of those thrifts and has an equity stake in most of them. FSLIC generally assessed the viability of the new entities before the transactions were approved. FSLIC's analyses showed that 9 out of 10 of the new thrifts we reviewed would be profitable, including the FSLIC assistance as income, within the first 5 years. (FSLIC had not done a viability analysis for thrifts in two of the transactions.)

We found, however, that FSLIC had not reduced the assistance income to the thrifts by the amount of the tax benefits they were required to return to FSLIC. Such reductions in income would affect both profitability and the regulatory capital levels projected, as FSLIC usually assumed all income will be retained. The implication of excluding tax benefits is that some of these new thrifts may not be viable without additional infusion of capital.

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The administration's bill authorizes the Resolution Trust Corporation to review and analyze these transactions, including all means by which costs can be reduced. We think this review should be required.

That concludes my prepared statement. My colleagues and I will be pleased to answer any questions.

Table 1:
INFORMATION ON 12 DEALS
(FSLIC - Supplied Data)
(millions)

TRANSACTION NAME (AND NUMBER OF THRIFTS)	ACQUIRED ASSETS	ACQUIRED LIABILITIES	FSLIC ESTIMATED COST (CASH) MERGER	FSLIC ESTIMATED COST (CASH) LIQUIDATION	FSLIC ESTIMATED COST (PRESENT VALUE) MERGER	FSLIC ESTIMATED COST (PRESENT VALUE) LIQUIDATION	ACQUIRER CONTRIBUTION	TAX BENEFIT TO FSLIC
SOUTHWEST PLAN								
Southwest Savings (4)	$3,998	$4,990	$3,521	$1,844	$1,980	$2,502	$25.0[a]	100%
Gibson (12)	2,217	3,193	2,379	1,166	1,314	1,546	48.0	100%
NuOlney (11)	3,750	4,300	2,293	1,041	1,287	1,668	80.0	60%
CFSB (15)	1,831	3,236	3,378	1,814	1,846	2,117	120.0	27%[b]
Utley/Ford (5)	12,006	13,026	8,908	6,281	5,046	6,822	315.0	28%[c]
Pacific (8)	854	1,151	987	530	566	662	37.5	25%
Centex (4)	323	649	813	417	429	464	26.5[d]	42%[e]
Hyperion (1)	4,400	4,700	2,200	1,111	1,372	1,492	200.0	42%[f]
NON SOUTHWEST PLAN								
D. P. Holdings (1)	954	1,407	696	600	566	700	20.0	0%
River Valley (3)	170	188	36	34	36	45	5.0	6%
First Nationwide[g] (4)	8,086	8,373	3,108	1,734	1,684	2,431	175.0	73%
Bass (1)	30,000	Not Available	Not Calculated		1,700	3,333	500.0	75%

[a] The acquirer did not contribute new capital. About $25 million in subordinated debt was converted to common stock.
[b] FSLIC is entitled to 33-1/3% of all tax benefits realized but is guaranteed minimum tax benefits of $11.1 m (NPV)
[c] FSLIC is entitled to 33-1/3% of all tax benefits realized calculated at a 30% tax rate. Assistance payments are tax effected on this basis but FSLIC is guaranteed a minimum of $30 m each year of the Agreement.
[d] $3.5 m of the $26.5 capital contribution represents the historical value of real estate.
[e] Negative Net Worth Note was reduced by $13.2 m as a prepayment of the estimated tax benefits due FSLIC for 1988; this amount is subject to adjustment after tax return is filed.
[f] Resulting entity will not generate sufficient taxable income to take advantage of most of the tax benefit items.
[g] Incorporating the asset backed transfer on December 9.

Source: FSLIC reported unaudited data.